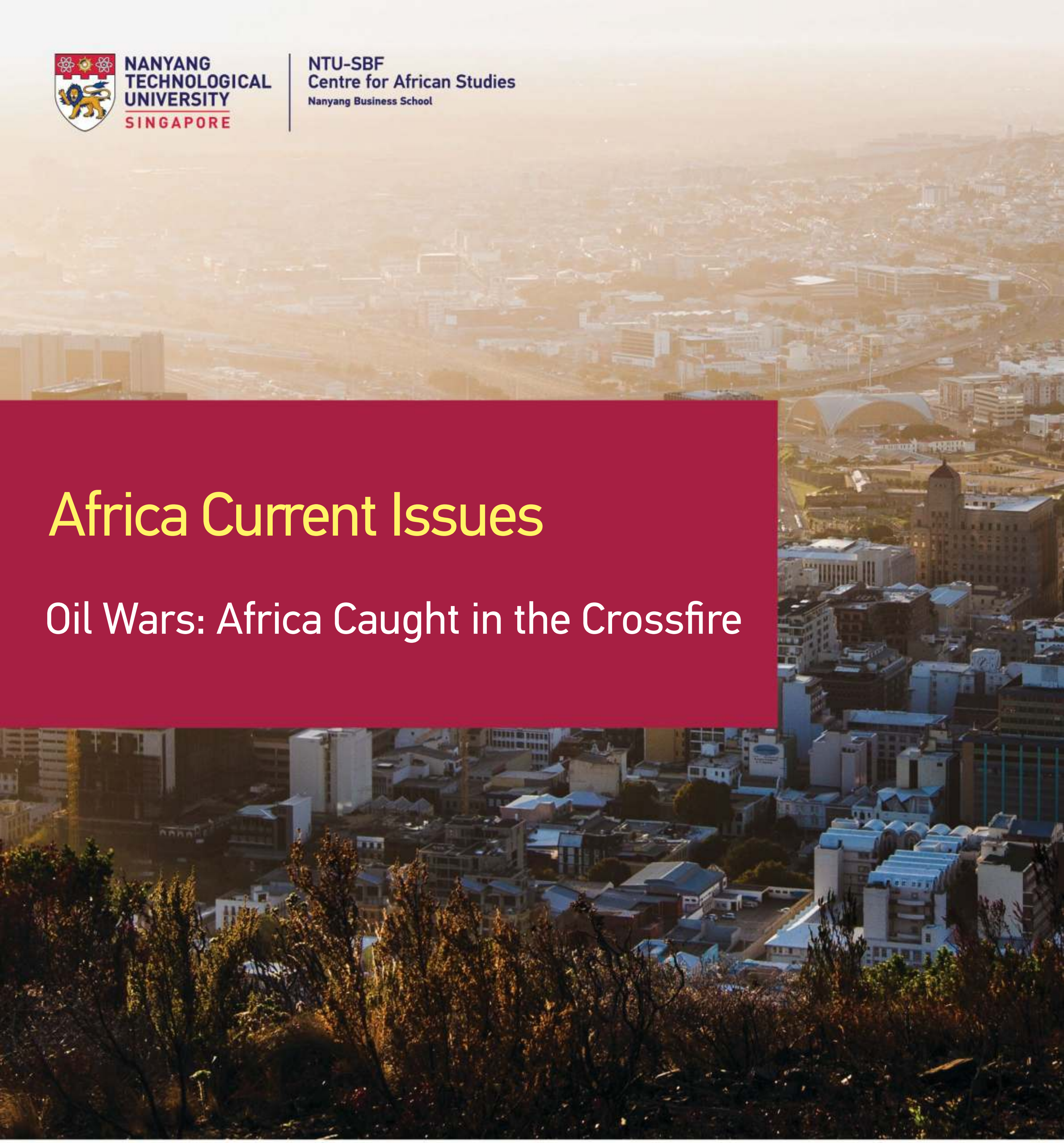

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# Africa Current Issues

## Oil Wars: Africa Caught in the Crossfire

Vol. 2020 - 18

# Oil Wars: Africa Caught in the Crossfire

Russia refused to accede to OPEC's March 2020 requests to cut oil production. The Saudi retaliation that followed sparked a violent sell-off in the commodity. Oil shed 30% of its value in a single day. Although oil prices then stabilized somewhat, the plunge (and continuing low prices) has important financial, trade and economic implications for African oil producers.

As mineral rich countries, most of Africa's oil producers are overly reliant on oil income. They have yet to diversify their tax and export revenue streams. This puts them at the mercy of political and economic actions by duelling countries, such as the Saudi and Russian stalemate.

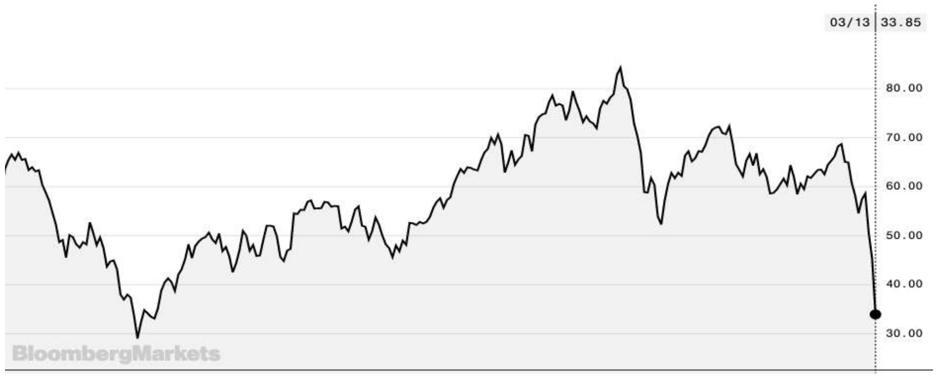
While these African countries may feel caught in the crossfire, it is ultimately the citizens and businesses of each country that will bear the full brunt of the economic fallout. Here we examine those consequences for Nigeria, Ghana, Angola and Gabon that are the major oil producing counties in Africa. This article unpacks their currency, foreign exchange and sovereign debt positions to better understand how well each can withstand the severe oil price shock.

The fall in oil prices may be temporary. The implications of the political standoff are likely not to be, and businesses will need to adapt to new market dynamics and address their overreliance on the windfalls of an oil-based economy.

### The global backdrop

Oil prices are in a tailspin. So is the relationship between Saudi Arabia and Russia, two of the largest oil producing nations. Brent crude opened 2020 trading at nearly USD 70 per barrel. The commodity now brings less than USD 30 per barrel[1], a near 60% plummet (Figure 1).

*Figure 1: Brent crude oil price per barrel*




Source: Bloomberg

The precipitous price plunge is not to blame for slowing global growth or the global COVID-19 pandemic. Rather, these two developments were catalysts for the primary driver, a political, economic and financial standoff between Saudi Arabia and Russia (the second and third biggest producers respectively) who together account for nearly a quarter of the world's oil output.[2] Despite making up 25% of output, their swing producer status comes not from their contribution to total production, but rather the low cost of that production.

Given the extent of downward pressure on oil prices, the Saudis called for deeper and longer production cuts at an extraordinary OPEC + (Organization of Petroleum Exporting Countries plus other countries, most notably Russia) meeting was convened in Vienna on 5 March 2020.

The Saudis attempted to strong-arm Russia into toeing the line – knowing that failure to do so would result in oil prices falling to unprofitable levels for all producers.[3] Russia balked at the move and the incensed Saudis retaliated by announcing they would slash their crude prices, ramp up production and flood a market already in oversupply.[4]

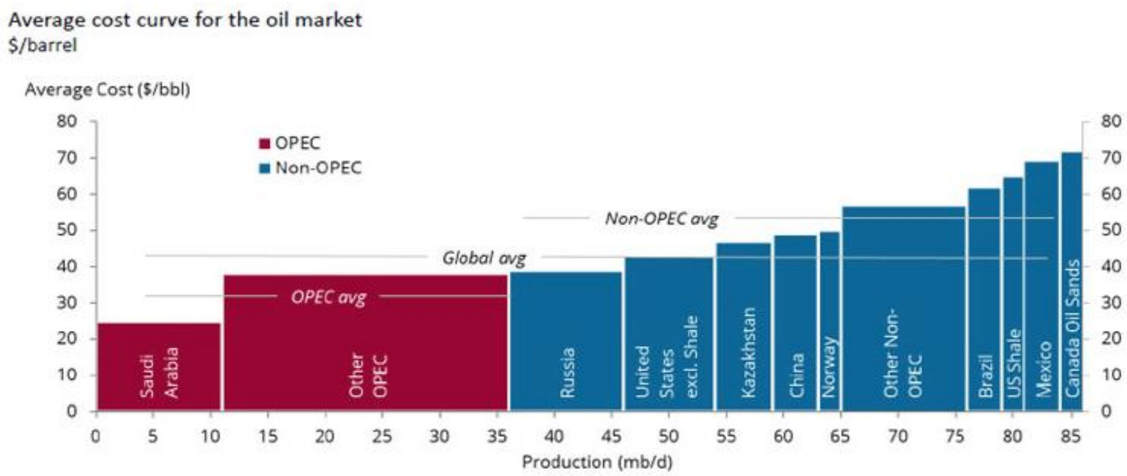
The move threatened Russia with economic and financial pain in the hope it would capitulate, but the Russians did not take kindly to the threat, calculating that they could ride out the loss-making oil price longer than could the Saudis. Thus, the two countries entered a war of attrition. None of the other oil producing countries has the fiscal resources of Russia or Saudi Arabia. There will be collateral damage. For these smaller producers, any fall in production and / or price inflicts enormous pressure on export revenue, their current account, fiscal balance and currency. The current environment inflicts both volume and value pressure.

The deadlock is an unprecedented departure from the solidarity normally displayed by oil producing countries. OPEC members usually act in lockstep to protect their interests. It also comes at a time when the global economy and financial markets are in turmoil following the supply and demand lockdowns caused by COVID-19.

In predicting which of the two countries will blink first, several factors emerge: 1) Production costs, 2) Currency reserves, 3) Country debt levels, and the 4) Intended political endgame. The Saudi (Mohammad Bin Salman) and Russian (Vladimir Putin) strongmen would have weighed these (and likely other) factors in plotting their strategy. At least one of the combatants, if not both, miscalculated.

Russia appears at a distinct disadvantage given that its per barrel oil production costs are almost twice that of Saudi Arabia (USD 20/barrel vs. Russia's USD 40/barrel – Figure 2).

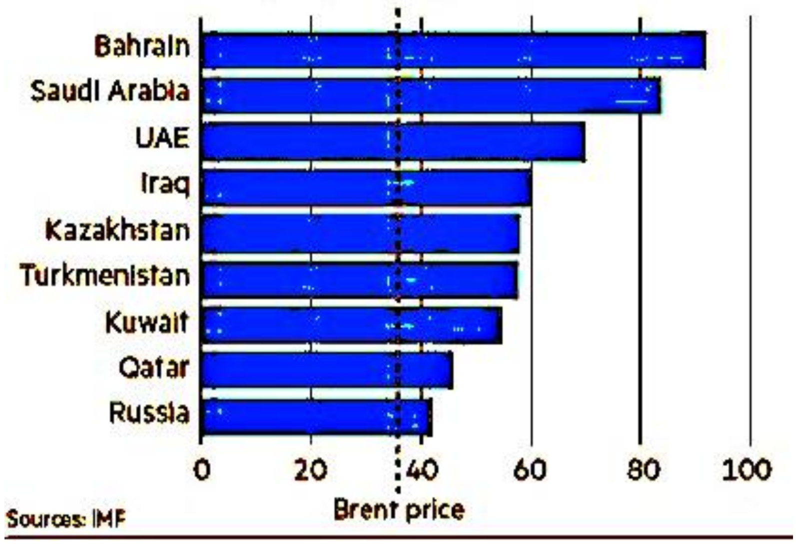
*Figure 2: Oil production costs per barrel*




Source: Financial Sense

Russia accumulated extensive gold and foreign exchange reserves (half a trillion dollars) over years of US sanctions, allowing it to absorb the USD 10/barrel loss at current prices.[5] Their low production cost (Meredith 2020) will enable the Saudis (also with half a trillion dollars in reserves) to eke out small profits at this price level. However, the Russian economy is far less diversified (and is thus more dependent on oil revenue), with loftier debt levels and higher fiscal breakeven requirements (Figure 3).

*Figure 3: Fiscal breakeven oil price*




Source: IMF and Financial Times

On this score, it seems the Saudis may have overplayed their hand, but neither country can afford to fold for fear of losing credibility and market making power. Politically, both Bin Salman and Putin seek to tighten their leadership stranglehold over their countries. To submit would strike a mortal blow to their power.[6]

Both states would benefit from driving higher cost US shale producers out of the market (no easy feat after the US government pledged financial support for its oil industry). The complex dynamics suggest that the showdown will come later rather than sooner –Russia can probably survive 10 years at current prices, while Saudi Arabia can withstand 4 years.[7] The standoff carries a high risk of dragging all oil producing countries down with them. Many African producers, already headed for balance of payments crises, may be among the first to fall.

**The African shakeout**

Halving oil prices to USD 30/barrel would reduce Sub-Saharan (SSA) Africa's exports by USD 30 billion.[8] This would undoubtedly be a significant setback for a continent looking toward the African Continental Free Trade Agreement (AfCFTA) to boost regional trade. In Africa, the sustained impact of weak oil prices will be uneven across different countries. Net oil importers will benefit from the heavily discounted price, but oil-producing countries will need to contend with massively reduced export revenue, weakening currencies, extensive drawdowns on foreign exchange reserves and the growing likelihood of a balance of payments crisis.

The four countries profiled below are the largest oil producers in SSA (Republic of Congo was excluded given its limited commercial viability at the moment). Country vulnerabilities were assessed on a broad range of metrics, including the % contribution of oil revenue to public sector revenue, contribution to GDP, debt as % of GDP and foreign exchange reserves, among others. This technique results in a relative risk assessment/peer comparison, and provides the basis for the vulnerability values in the table below.

*Table 1: Economic vulnerability to oil shock*

| | Nigeria | Ghana | Angola | Gabon |
|---|---|---|---|---|
| **Oil dependency** | Medium | Medium | High | High |
| **Fiscal impact** | High | Medium | High | High |
| **Risk to reserves** | High | Medium | High | High |
| **Currency impact** | High | Medium | Medium | Low |
| **Debt burden** | Low | Medium | High | Medium |
| **GDP growth risk** | Medium | Medium | High | High |

*Red = high vulnerability, amber = medium vulnerability, green = low vulnerability

**Nigeria**

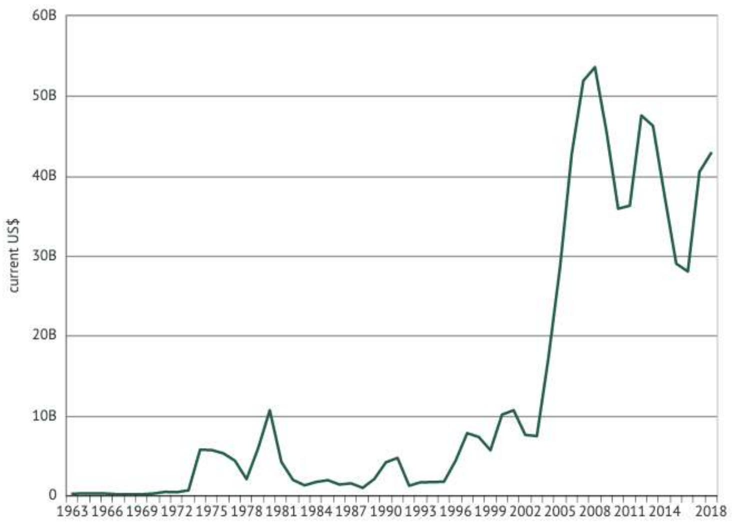
The oil price collapse came at a terrible time for Nigeria, just emerging from recession. In late 2019, the country's parliament passed a record USD 35 billion budget, to be financed by foreign and domestic debt. The budget deficit was to be 1.52% of GDP, assuming crude oil production of 2.08 million barrels per day at a price of USD 57/barrel.[9] The assumptions that supported this spending are now invalid, and the country must review its spending plans only three months after passing this budget.[10]

Given oil market turmoil, Nigeria slashed its oil benchmark price to USD 30/barrel and cut its capital expenditure budget by 20%.[11] Oil revenue is now expected to halve, forecasted customs revenue has been adjusted to reflect on lower trade volumes, and some privatisation projects have been suspended. Further measures include a public sector headcount freeze. In brief, more money is needed to fight the COVID-19 outbreak, and a lot less income is expected due to depressed oil prices.

*Currency and reserves*

The naira, set by the Central Bank of Nigeria (CBN), which has been defending it using its limited (USD 30 billion) currency reserves, dropped dramatically on the parallel market, leading to a dollar shortage, leaving many Nigerians and businesses unable to trade.[12] Calls had been growing for the CBN to allow the devaluation of the naira, which would push up already elevated inflation (12.2%) stoked by an increase in the value added tax (VAT) rate.

*Figure 4: Nigeria foreign exchange reserves*




Source: Knoema

In Nigeria, foreign-exchange reserves fell 20% this year to USD 45 billion. The central bank's limit before it triggers devaluation of the naira is USD 30 billion. The central bank capitulated on 20 March, devaluing the naira by 15% (Ohuocha 2020). This decision suggests the country is burning through reserves to defend the currency. How much is available to weather the oil price shock is yet to be seen (Figure 4).

*Debt*

Nigeria's bonds have plumbed new depths with yields on Nigeria's 2031 Eurobond nearly doubling to 12.1% from 6.8% on February 21.[13] The higher interest payments and weaker currency for a country that uses 50% of its revenue for debt service costs implies that Nigeria's fiscal position will deteriorate meaningfully, requiring expenditure cuts. The International Monetary Fund (IMF) announced on 12 March 2020 that it would be working with Nigerian authorities to assess the impact of the sharp fall in oil prices.

Just a month prior, Parliament acceded to Buhari's request of USD 22.7 billion in foreign borrowing, but market turmoil and tighter credit conditions will likely see the country unable to raise funding.[14] More likely is that Nigeria will have to turn to the IMF for funding.

*Business impact*

Businesses in Nigeria should brace for very difficult conditions ahead. The recent increase in the VAT rate, coupled with a weaker currency, potentially leads to higher inflation (despite the lower oil price) and interest rates, putting extreme pressure on both demand and margins.

Policy makers face a dilemma. They will be reluctant to cut back on the promised capital spending plans for fear of reneging on election promises, but the capital markets have become exceedingly expensive for new issuances and yields on debt are already rocketing.

With reserves under pressure from absorbing the blow of lower oil price and having to defend currencies, governments and central banks are running out of options. Much of the pain will have to be balanced from the expenditure side, where unpopular choices such as wage and headcount freezes (or even outright reductions to the public wage bill) will have to be made. Failure to do so may see it forced upon them should they need to turn to the IMF for assistance.

Tighter dollar liquidity, market shortages and the growing likelihood of more stringent exchange controls could lead to multinational companies finding it virtually impossible to repatriate funds. Additionally, Nigerian regulators are rumoured to use fiscal constraints to interfere in business sectors (as they did with MTN in the telecommunications space) by imposing large and often unwarranted fines.

The darkening economic outlook combined with the impact of COVID-19 containment measures also increases the risk of civil disobedience and social unrest, which will only exacerbate an already worsening situation.

**Ghana**

Unlike Nigeria, Ghana is a relatively well-diversified economy, yet still overly dependent on oil prices and sales for budget revenue. The country's 2020 budget projected oil revenue of USD 8.9 billion, premised on an oil price of USD 58/barrel (30% of national revenue), but revenue now looks set to fall to a little over USD 4 billion.[15]

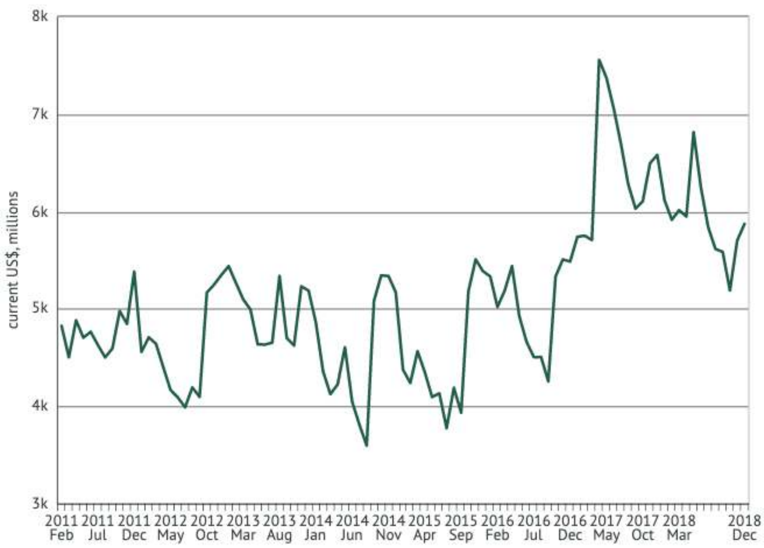
At the current oil price, government and producers are making a USD 8/barrel loss. To offset these losses from the lower oil price, government has decided not to pass the fuel price windfall on to customers.[16] The move met resistance from consumer advocacy group, the Chamber of Petroleum Consumers (COPEC) who urge oil companies to reduce fuel prices.[17]

*Currency and reserves*

Despite the oil price collapse, the cedi remains relatively stable to the USD, even strengthening at times. This should help the government keep inflation, currently hovering at 8%, in check even though no relief is expected at the pump.

Much of the currency stability comes on the back of a preceding economic recovery that has allowed foreign exchange reserves to recover somewhat (Figure 5). Nevertheless, reserves remain comparatively low and while there is scope for further interest rate cuts, the expected fiscal constraints from the lower oil price are set to place the economy under significant strain.

*Figure 5: Ghana foreign exchange reserves (USD)*

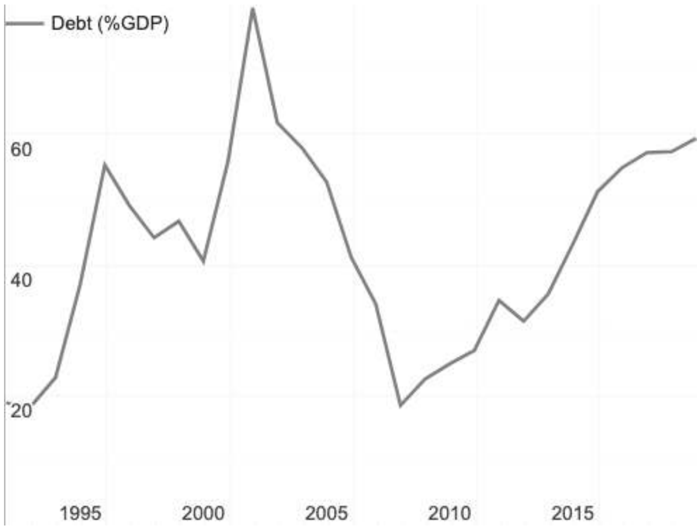



Source: Knoema

*Debt*

Ghana's debt (USD 37.3 billion) to GDP ratio is currently 63% (Figure 6). These debt levels, which have risen 10 percentage points since 2017, are unsustainable even at far higher oil prices. The country is already under IMF supervision.[18]

*Figure 6: Ghana debt to GDP ratio*




Source: Country Economy

Borrowing conditions are also increasingly unfavourable. Ghana's 2029 Eurobond saw its yield rise from 6.8% to 10.9%. Opportunities in the Eurobond market are fast closing as risk aversion takes hold following the COVID-19 outbreak.

Due to the COVID-19 outbreak and fiscal constraints imposed by lower oil prices, the country must now approach the IMF and the World Bank to seek USD 100 million in credit. This places the country squarely back under their influence and delays their scheduled exit from the IMF supervision programme.[19]

*Business impact*

Several multinational oil majors operating in Ghana dramatically reduced their oil output and price projections. This will deliver a significant hit to tax revenue.[20] The Government expects significantly lower foreign direct investment from oil companies over the next three years, which will hamper the country's economic recovery.

Employment is set to suffer due to the fall in capital expenditure, threatening the recovery in household spending. The national budget submitted mid-March is almost certain to undergo revisions given current oil prices. This will affect social service delivery and infrastructure investment. While the prospect of civil disobedience remains slim, it cannot be ruled out. The greatest risk posed to businesses operating in the country, however, is to the broader impact of slowing economic growth via weaker oil revenues.

Higher borrowing costs and tighter credit markets will see rising household and business defaults, and the country's reform aimed at economic diversification and a greater emphasis on consumption will suffer a longer-term setback.

**Angola**

Angola will be one of the hardest hit African oil producing economies, as it is the least diversified. The country is still struggling to emerge from the economic crisis caused by the previous fall in crude prices from 2014 to 2017.[21] An early emergence from a four-year recession looks highly unlikely.[22]

Angola is set to be impacted on two fronts. Firstly, 90% of Angola's export revenue comes from oil, making tax revenue and spending plans almost entirely dependent on oil prices and demand. Secondly, most of its oil production goes to China, whose economy is crippled by the outbreak of COVID-19. Thus, Angola faces the double blow of massively lower prices and a collapse in demand.

This opens the possibility of political tussles as President Joao Lourenco tries to diversify the economy and stamp out corruption.[23] The reforms he has undertaken, which include the privatisation of state-owned companies and a three-year USD 3.7 billion loan from the IMF have made him a target of opponents.

*Currency and reserves*

The Angolan kwanza fell 6% since 12 March, cushioned somewhat by the IMF's assistance programme. Nevertheless, inflation at approximately 30% y/y gives the central bank little room for monetary policy intervention to stimulate growth. There is no fiscal policy space, requiring budget adjustments on the expenditure side to maintain debt metrics.

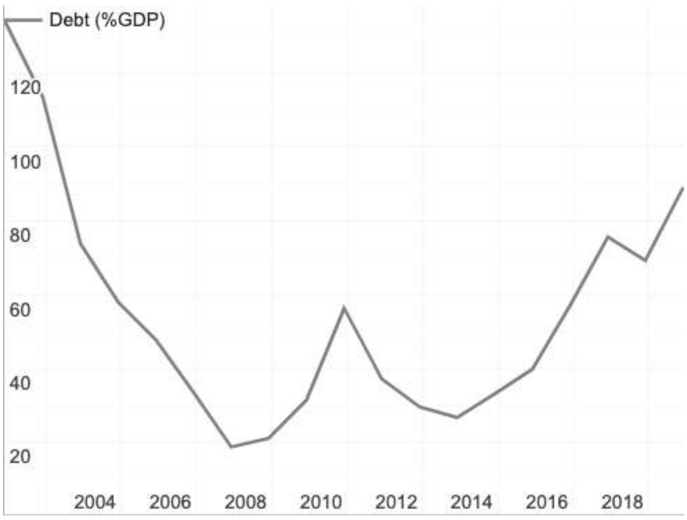
As of March, foreign exchange reserves stood at USD 16.8 billion, with debt servicing costs estimated at USD 8 billion for this year. Adding additional reserve buffers will be extremely challenging at the current oil price. Budget expenditure reduction plans are under review.

*Debt*

Angola's Eurobonds saw yields triple to more than 23% over the past month, making any additional capital market issuances exceedingly difficult. Further restructuring of the country's debt over an even longer period appears inevitable.

Most importantly for the country, measures to reduce public debt from approximately 100% of GDP in 2019 to below 60% over the medium term will be severely compromised and Angola will be dependent on IMF assistance for some time to come (Figure 7).

*Figure 7: Angolan debt-to-GDP ratio*




Source: Knoema

Even with an oil price recovery over the short-term, the impact of COVID-19 on the global economy, weaker oil demand and higher borrowing costs will lead to a collapse in GDP and a surge in debt-to-GDP levels.

*Business impact*

Angola has little space to provide monetary relief, due mainly to elevated inflation rates. High current debt levels will inhibit any form of fiscal relief, and businesses in Angola must brace for a sharp deterioration in economic conditions.

The depressed oil price will almost certainly lead to a dramatic fall in fixed investment. While the country is unlikely to introduce exchange controls under the IMF programme, bank liquidity and conditions on credit will force businesses dependent on the oil sector to close. The knock-on effect for unemployment and consumption will further depress the country's worsening economic outlook.

**Gabon**

Gabon's economic growth for the past 3 years was less than 1% y/y. Gabon never fully recovered from the 2014 oil price shock. Under an IMF programme, the country recently received a further USD 123.5 million disbursement. Similar to Angola, the country is heavily dependent on oil sales to generate revenue.[24]

Even under the guidance of the IMF, the country has been slow to introduce structural reforms, largely due to corruption and mismanagement. The lack of reform led to a sharp fall in fixed investment. This situation is likely to worsen with substantially lower oil prices. What makes Gabon more susceptible to an oil shock than other African country is not its weak fundamentals, but the rigidity of its currency.

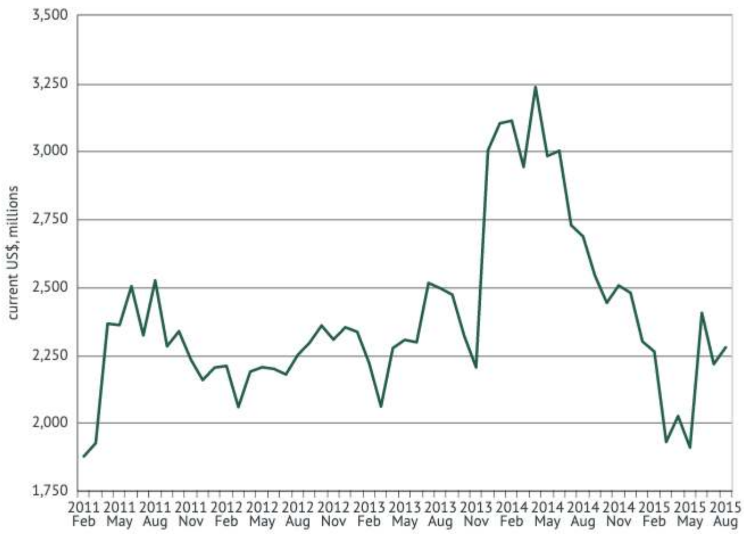
*Currency and reserves*

Unlike Nigeria, Ghana and Angola, Gabon is part of the Central African Currency regime (CFA) fixed to the Euro. While this shelters the economy from significantly higher inflation, it also provides very little independence and leeway for monetary policy stimulus. Moreover, the fixed currency prevents a devaluation move to partially offset the impact of weak oil prices.

Speculation has been that Central African States would follow their West African Economic Monetary Union (WAEMU) in adopting the Eco, a new currency which while still pegged to the Euro, would allow greater independence in managing foreign currency reserves. Doing so would provide more fiscal flexibility but this will not happen in time to stave off the impact of a materially lower oil price.

Reserve buffers currently stand at 3 months of import cover (USD 2.25 billion), inadequate to withstand a long period of low oil prices. Reserves are thus likely to run down faster than anticipated (Figure 8).

*Figure 8: Gabonese foreign exchange reserves*




Source: Knoema

*Debt*

Low in relative terms, Gabon's public debt stands at 42.5% of GDP. As with Angola the debt-to-GDP ratio is set for a sharp increase. More debt (the numerator) will be required under the current economic conditions (likely from the IMF), while the GDP (the denominator) is set to plunge. This will leave the country in breach of several fiscal commitments and see the IMF impose more stringent austerity measures on the nation.

*Business impact*

The dual impact of the COVID-19 outbreak and halving of the international oil price has already seen companies operating in Gabon dramatically scale back project expansion plans, such as Norwegian BW Oil.[25] Panoro Energy too, has cut offshore exploration plans by 40%.[26]

These actions will have fiscal and economic ramifications. They will severely dent the country's sorely needed capital expenditure and infrastructure plans.[27] This will set developmental progress back several years. Operating conditions are set to remain extremely challenging and the cost of doing business will increase.

**The sectorial fallout**

The battle will spare few sectors, if any. The most obvious impact will be on the oil and gas sector, which faces enormous capex cutbacks and a likely rise in company bankruptcies.

The greatest threats facing African oil producing countries are to their fiscal positions. These threats emanate from the loss of oil and gas royalties, tax and export revenue. Typically seen as a negative, the fact that many are already under IMF supervision may be a blessing in disguise, as it cushions some of the currency and rate volatility that many states would experience in the event of such a powerful economic shock.

*Table 2: Sectoral impact of oil price collapse.*

| | Medium term African sectoral impact |
|---|---|
| **Oil & Gas** | Sharp losses (production costs higher than sale price) will force a halt to capex and exploration, while many smaller producers with higher costs will face bankruptcies. |
| **Construction** | Much lower taxes flowing to government will necessitate national budgets be revised, with spending diverted away from capital projects that will see project pipelines dry up. Competition for remaining work will be intense, shrinking margins. |
| **Manufacturing** | Input costs (transportation) are expected to fall which should put downward pressure on producer price inflation and ultimately end user inflation. Slower economic growth will, however, weigh on demand. Suppliers into oil sector should expect significant pressure. |
| **Retail** | Inflation should fall meaningfully, provided government pass the cost savings on to the end consumer - government may try retain savings to cushion revenue shortfall. Lower inflation may allow for interest rate relief that would be a tailwind for consumption |
| **Financial services** | Rising bad debts from oil producers and suppliers into the sector. Rising unemployment will see an increase in non-performing loans and business defaults. Cost of credit set to increase dramatically as bond yields rise, while potential rate cuts dent endowment income. |

*Red = high vulnerability, amber = medium vulnerability, green = low vulnerability

Nevertheless, the reduced fiscal space and increased probability of sovereign defaults pose wider dangers for industry sectors, beyond oil. After oil, the construction sector is potentially the most vulnerable, as governments scramble to reassess budgets to cope with significantly lower income expectations. Public sector fixed investment projects are usually among the first victims in the budget reallocation process.

Many manufacturing concerns depend on the oil, construction and peripheral sectors for business. They will see dramatically reduced orders, and companies competing for work are likely to cut margins in order to keep their doors open. Many will not survive.

The effects of rising unemployment will feed into lower household consumption and retailers of durable and semi-durable goods will be particularly vulnerable as household expenditure shifts to necessities. The employment picture is grim. These countries are coming under pressure to reduce their public sector wage bill. Wage increases are unlikely to match inflation, and headcount freezes already appear.

The fracas will not spare the financial sector. Credit conditions will tighten as defaults rise. Rising sovereign bond yields make central bank borrowing more expensive. These costs inevitably pass on to businesses and consumers.

**The winners and losers**

Understandably, attention focuses mainly on the impact on oil producing countries. Nigeria, Ghana, Angola, Gabon and several North African countries remain heavily dependent on oil taxes and royalties for revenues. At current oil prices, many governments may need to radically revisit revenue and budget assumptions, and curb public spending plans. These moves will set back progress toward achieving national and regional development goals.

For non-oil producing economies, however, for whom importing oil or fuel is a cost, rather than a revenue generator, the lower oil price will provide much needed relief against the backdrop of slowing global growth.

Oil importing countries like South Africa and Kenya, as well as all the Southern and East African countries they produce fuel for are set to see a near 50% reduction in oil / fuel import costs. The direct impact will be through lower foreign exchange outflows that will help narrow their current account deficits (for some widen the surplus) and provide support to their currencies. This opens the door for softer inflation prints, interest rate cuts and support for consumer spending, all of which will provide growth momentum.

On a sectoral level, the transport and logistics industries are set to benefit the most, followed by retailers (lower logistics costs, lower inflation, improved household consumption. Manufacturers too will reap the benefits of lower transportation / logistics costs and an uptick in demand as consumers realise slightly better buying power.

**Outlook: Lower for longer**

The longer-term economic outlook for Africa's oil countries is considerably worse than it was just one month ago. The stand-off between Russia and Saudi Arabia led to a collapse in oil prices. Of greater concern is the potential duration of the impasse. Both economies have large foreign exchange reserves and well capitalised sovereign wealth funds. They should be able to endure years of sub-USD 30/barrel oil prices, a luxury denied to most other oil producers.

The current oil price crisis is unlike that of 2014. In 2014, the oil market was a victim of its own success. USD 100/barrel opened the door for high cost producers that flooded the market and led to oversupply. The market reached equilibrium at roughly USD 50/barrel. This time, a global shock (COVID-19) coupled with much higher fiscal breakeven costs threatens to drag out the swing producer brinkmanship scenario. While unlikely, even a speedy resolution between the oil producing heavyweights, and large production cutbacks will not revive flagging oil prices, since the ramifications of the trade war and COVID-19 global shocks are poised to endure.

African countries have ridden the coattails of their mineral wealth at the expense of economic diversification. They must now identify, explore and invest in new industry sectors such as agriculture and technology. Businesses should use the opportunity to further maximise efficiencies rather than rely on the savings windfall or hedge their costs should they be in a position to do so. Governments should replenish oil reserves. This is also an important opportunity to tighten up on corruption, mismanagement and national budget expenditure, prioritising spending that will deliver sustainable and growth enhancing returns.

What is certain, is that failure to do so will see these countries in the same position when oil prices collapse again, and they will. Persistent boom and bust scenarios should not be a hallmark of these economies, as they exacerbate societal fragilities and political instability. If ever there was a time not to waste a good crisis, it is now.

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